EARNINGS QUALITY BASED ON FAIR VALUE ACCOUNTING

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Abstract

Fair value measurements are on the Transilvania Bank Group earnings from December 31, 2017 to December 31, 2018. We search on the correlation between fair value measurements and earnings quality. As the fair value is an independent variable, the earnings quality is a dependent variable. The data collected are from the Transilvania Bank Group annual reports between December 31, 2017 and December 31, 2018. The predictability, accruals quality, earnings smoothing and value relevance are the most important measures of earnings quality. Earnings quality and the quality of accounting information are in direct relation. The impact of fair value accounting on earnings quality is significant. With the adoption of fair values, earnings predictability at Transilvania Bank Group became quite high due to the variability of income. This thing alters the quality of the earnings and thus affects the choices that stakeholders can make.

Keywords: *earnings quality, earnings predictability, bank, fair value accounting, financial statements.*

1. Introduction

Barth, Beaver and Landsman[1] considered, in 2001, that revenue is, of course, considered an indirect indicator for assessing the quality of accounting standards, as it shows a direct relationship between the quality of revenue and the quality of accounting information.

Sodan, in 2015, showed that fair value information predicts future cash flows and is the current assumption of the value relevance of research at fair value. Therefore, the usefulness of fair value information is, of course, studied directly by analyzing its predictive power in terms of future cash flows and future earnings. So Barth, in 1994, said that fair value measurements are given by the present value of expected future cash flows, so if fair values are reliable measures of asset values, changes in fair values (i.e. unrealized gains and losses at fair value) would it must be reflected in future performance changes.

Thus, if the fair value estimates are not reliable, then the correlation with future performance measures will not be taken into account. Among the most important accounting tasks is the choice of the correct valuation method for valuing assets and liabilities.

Then, it is not necessary to measure the correlation between fair value estimates and market prices or yields.

Many scientists such as McDonough and Shakespeare, in 2015, confirmed that the financial position and results of economic activities represented in the balance sheets and profit and loss statements depend on the current reality and the methods of estimating and calculating the reported indicators.

The concept of fair value emerged in the nineteenth and early twentieth centuries, but recently there has been much research and controversy among researchers calling for its cessation due to misuse and manipulation. accounting numbers when preparing financial statements.

Thomason, in 2017, showed that fair value abuse peaked in the 1920s in many developed countries where prosperity and inflation fueled the development of over-optimism of values, and many of them declined steadily due to the global recession. Between 2006 and 2007, new accounting situations were developed that broadened the scope of fair value accounting, leading to a discussion that extended beyond the accounting profession to the rest of the business community.

The predictability, accruals quality, earnings smoothing and value relevance are the most important measures of earnings quality. Earnings quality and the quality of accounting information are in direct relation. The impact of fair value accounting on earnings quality is significant.

1.1. Earnings quality based on fair value accounting

Although IAS 39 and FAS 115 were similar in adopting a mixed approach (both fair value and historical cost models), Sodan[2] thought, in 2015, that information becomes more relevant with the application of fair value, this approach providing users financial statements with appropriate information to make the right decisions. Then, the fair value approach has emerged to cover the shortcomings resulting from the application of the

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[1] Barth., M. E., Beaver, W. H., & Landsman, W. R. (2001). The relevance of the value relevance literature for financial accounting standard setting: another view. Journal of Accounting and Economics, 31(1-3), 77-104.Available at: https://doi.org/10.1016/s0165-4101(01)00019-2.

[2] Sodan, S. (2015). The impact of fair value accounting on earnings quality in eastern European countries. Procedia Economics and Finance, 32, 1769-1786. Available at: https://doi.org/10.1016/s2212-5671(15)01481-1.

historical cost approach. Schipper and Vincent, in 2003, predicted the continuity of corporate earnings in the coming periods, as long as financial analysts believe that financial statements as the main source on which they rely for information analysis and rational decision making. Chen, Lo, Tsang and Zhang, in 2013, noted that the quality of earnings is an indicator of dividends, because these dividends were important things indispensable in making investment decisions. Barth, Beaver and Landsman, in 2001, considered that earnings are valued, of course, as indirect indicators for assessing the quality of accounting standards, because there is a direct relationship between the quality of earnings and the quality of accounting information. Persistence, predictability, accruals quality, earnings smoothing and value relevance are various measures of earnings quality. Predictability tells us the idea that earnings are of higher quality and are more beneficial for predicting future earnings. Then it noted that the predictive power of profits is affected by the time series of earnings and the fluctuation of business operations, the economic environment and the accounting system used by companies. Sodan, in 2015, observed that the initial assumption of the value relevance of the research at fair value was that fair value information may predict future cash flows. We estimate the correlation between fair value estimates and market prices or returns, then the usefulness of fair value information is, of course, directly observed by analyzing its predictive power in terms of future cash flows and future earnings. Barth stated in 1994 that fair value estimates mean the present value of expected future cash flows, so if fair values are reliable measures of asset values, changes in fair values (i.e. unrealized gains and losses in fair value) must be reflected in changes in fair value future performance.

2. Earnings at Transilvania S.A. Bank

Transilvania S.A. Bank ("Parent Company", "BT") is a joint stock company registered in Romania. The Bank started its activity as a banking company in 1993, being authorized by the National Bank of Romania ("BNR", "Central Bank") to carry out activities in the banking field. The bank started in 1994 and its services relate to banking for legal entities and individuals.

The individual and consolidated financial statements have been prepared on the basis of the historical cost convention, except for financial assets recognized at fair value through profit or loss, financial assets at fair value through other comprehensive income and revaluation property, plant and equipment and real estate investments, except those for which the fair value cannot be credibly established.

(i) Foreign currency transactions

Transactions denominated in foreign currency are recorded in lei at the official exchange rate of the settlement date of the transaction. Exchange differences resulting from the conclusion of these transactions expressed in foreign currency are highlighted in the statement of profit or loss at the date of transactions using exchange rate from this date.

Monetary assets and liabilities recorded in foreign currencies at the date of preparation of the consolidated statement and the individual financial position items are expressed in the functional currency at the exchange rate on that day.

The conversion differences are presented in the result of the exercise.

Non-monetary assets and liabilities that are measured at historical cost in foreign currency are recorded in the functional currency at the exchange rate on the date of the transaction. Non-monetary assets and liabilities denominated in foreign currency that are measured at fair value are translated into the currency at the exchange rate on the date on which the fair value was determined.

The conversion differences are presented in the result of the exercise.

(ii) Conversion of operations into foreign currency

Results and financial position of operations conducted in a currency other than the currency and the Group's presentation currency are converted into this functional currency as follows:

- the assets and liabilities, both monetary and non-monetary, of this entity have been converted to the closing rate at the date of the consolidated and individual statement of financial position;

- the income and expenditure items of these operations were transformed at the average exchange rate, as an estimate for exchange rates related to transaction data;

- all the resulting differences were classified as other elements of the overall result up to when the investment is transferred.

In accordance with IAS 29 and IAS 21, the financial statements of an enterprise whose functional currency is the currency of a hyperinflationary economy should be presented in terms of purchasing power currency of the currency at the date of preparation of the consolidated and individual statement of financial position, I.e. non-monetary items are restated by applying the general price index from the date acquisition or contribution.

IAS 29 stipulates that an economy is considered hyperinflationary if, among other factors, the cumulative inflation index exceeds 100% over a period of three years. The continuous decrease of the inflation rate and other factors related to the characteristics of the economic environment in Romania indicates that the economy whose functional currency has been adopted by the Group of ceased to be hyperinflationary, with effect on financial periods starting January 1, 2004.

Therefore, the provisions of IAS 29 have not been adopted in the preparation of the financial statements consolidated and individual. Thus, the values expressed in the current unit of measurement on December 31, 2003 are treated as the basis for the carrying amounts reported in these consolidated financial statements and individual and do not represent valued values, replacement cost, or any other measure of value current assets or prices at which the transactions would take place at this time.

2.1. The fair value of financial assets and liabilities

Fair value is the price that would have been collected for the sale of an asset or paid for the transfer of a debt in a regulated transaction between market participants at the valuation date. The fair value is best highlighted by a price dictated by the market, if it exists.

The Group and the Bank measure the fair value of financial instruments using one of the following ranking methods:

- Level 1 in the fair value hierarchy

The fair value of financial assets and liabilities allocated to Level 1 of the fair value hierarchy is determined on the basis of quoted prices on active markets related to financial assets and liabilities identical. The price quotations used are regularly and immediately available on active markets / indices exchange and prices that represent current and regular market transactions according to the principle of market price.

- Level 2 in the fair value hierarchy

The fair value of the financial assets and liabilities allocated to level 2 is determined using valuation models based on observable market data when there are no market prices available.

For level 2 valuations, they are usually used as observable market parameters interest rates and yield curves observable at commonly quoted intervals, default credit and volatility.

- Level 3 in the fair value hierarchy

The fair value of the financial assets and liabilities allocated to level 3 is determined using data which are not based on observable market information (unobservable input data which must reflect the assumptions that market participants would use in setting the price an asset or a liability, including risk assumptions).

The objective of valuation techniques is to determine the fair value, which should reflect the price that would be obtained following a transaction under normal market conditions for the financial instrument, on preparation of consolidated financial statements.

The availability of observable data and models in the market reduces the need for estimates and management judgments and the uncertainty associated with determining fair value.

Data availability and observable patterns in the market depends on the products in the market and is inclined to change on the basis of specific events and general conditions in the financial market.

The fair value of financial instruments that are not traded in an active market are determined using evaluation techniques with market observable data.

Leadership uses judgment to select the valuation method and issue assumptions based mainly on existing market conditions at the date of preparation of the consolidated statement of financial position.

i) Hierarchical analysis of the fair value of financial instruments held at fair value at level 1 of the fair value hierarchy, the Group and the Bank classified in the asset category: instruments of equity and debt instruments held at fair value through profit or loss and loss, liabilities classified as assets measured at fair value through other comprehensive income globally (before January 1, 2018 classified as available-for-sale assets), except bonds issued by City Halls.

At level 2 of the fair value hierarchy, the Group and the Bank classified in the asset category: instruments derivatives held at fair value through profit or loss, bonds classified as assets measured at fair value through other comprehensive (income before January 1, 2018 classified as available-for-sale assets) issued by City Halls and in the debt category: derivatives classified as financial liabilities held for trading at level 3 of the fair value hierarchy, the Bank and the Group classified in the asset category: instruments equity, property, plant and equipment and real estate investments.

As of January 1, 2018, the Group and the Bank have classified financial assets and liabilities in the following categories:

- Financial assets at fair value through profit or loss (FVPL);
- Financial assets at fair value through other comprehensive income (FVOCI);
- Financial assets at amortized cost.

The Group and the Bank recognize all financial assets and liabilities at the date of trading. Date

trading date is the date on which the Group and the Bank commit to buy or sell an asset.

After initial recognition, a financial asset is classified as measured at amortized cost, only if two conditions are met simultaneously:

- the asset is held within a business model whose objective is to keep the assets to collect contractual cash flows;
- the contractual terms of the financial asset give rise, at specified dates, to cash flows representing only principal and interest payments.

Financial assets classified as measured at fair value through other comprehensive income are those financial assets that are held both for the collection of cash flows and for their sale.

Financial assets that do not meet the cash flow criteria (SPPI test) must be valued at fair value (e.g. derivatives or units background). The embedded derivatives are no longer separated from the host financial assets, but will be valued as a whole with the non-derivative financial instrument in terms of compliance with the conditions cash flow collection.

Investments in equity instruments are always measured at fair value. However, management may make an irrevocable choice to present changes in fair value other elements of the overall result, provided that the instrument is not held for trading.

Therefore, if one chooses to measure equity instruments at fair value through other comprehensive income, then these financial instruments will not represent monetary items, and the cumulative gain or loss, including the related foreign exchange component, will be transferred to the equity of the entity at the time of derecognition instrument.

If the equity instrument is held for trading, changes in fair value are presented in profit or loss.

Financial liabilities are classified after initial measurement at amortized cost, except when they are measured at fair value through profit or loss (financial liabilities derivative instruments). The embedded derivatives are separated from the host contract in the case of financial liabilities.

As of January 1, 2018, the Group and the Bank measure the equity instruments obligatorily measured at fair value through profit or loss. They were included in this category shares held in VISA Inc.

Gains and losses on investments in equity instruments measured at fair value through profit or loss are included in the line “Gains on financial instruments at fair value through profit or loss” in the statement of profit or loss.

Investments in equity instruments, for which the Group and the Bank do not express an intention to maximize cash flows through sale or these financial assets are not included in the trading book, have been classified as financial assets valued at fair value through profit or loss. and loss. In this case, the Group and the Bank have made an irrevocable choice to present changes in fair values in the comprehensive income, and the gains or losses on these instruments will be transferred directly to the Group's equity, without recycling these items in profit or loss.

Government bonds, bonds issued by town halls and other financial and non-financial companies were classified at fair value through other elements of the overall result, taking into account the criteria of the SPPI test and the inclusion in the business model of collecting contractual cash flows and selling of assets. As of January 1, 2018, the Group and the Bank recognized a provision for expected credit losses related to these assets measured at fair value through other comprehensive income. This provision is recognized in other comprehensive income and will not reduce the carrying amount of the financial asset.

The obligations issued by credit institutions and other financial institutions that meet the criteria of the SPPI test and the inclusion in the business model of collecting contractual cash flows were classified at amortized cost.

As of January 1, 2018, the Group and the Bank recognized adjustments of depreciation related to the class of financial assets valued at amortized cost.

Mutual funds held in mutual funds are measured at fair value through profit or loss.

They are treated as debt instruments, do not meet the criteria for collecting cash flows and do not fall within the trading portfolio of the Group and the Bank. Therefore, they were included in the category of financial assets valued at fair value.

In the individual statement of financial position, equity instruments representing investments in associates and subsidiaries continue to be measured at cost in accordance with IAS 27 "Individual financial statements".

Derivative financial instruments are measured at fair value through profit or loss.

Impairment under IFRS 9 is based on anticipated losses and requires early recognition of expected future losses. IFRS 9 eliminates profit or loss volatility caused by changes in credit risk related to liabilities designated at fair value. Specifically, gains due to credit risk impairment will no longer be recognized in the income statement.

The calculation of expected losses shall use, at the reporting date, the effective interest rate established at the initial recognition or an approximation thereof. If a financial asset has a variable interest rate, the expected loss on credit must be determined using the current effective interest rate. For financial assets acquired or issued impaired as a result of credit risk, the expected credit losses must be determined using the credit-adjusted effective interest rate set at the initial recognition.

In some circumstances, renegotiating or changing the contractual cash flows of financial assets leads recognition of existing financial assets. If it significantly changes the contractual conditions on the background of commercial renegotiations, both at the client's request and at the Bank's initiative, the derecognition of the existing financial asset and the subsequent recognition of the modified financial asset takes place, the modified financial asset being considered "new" financial asset.

In 2018, the average annual inflation stood at 4.6% (4.1% on the EU harmonized index of consumer prices), the highest in 2011.

However, inflation slowed in the last quarter of 2018, re-entering the Central Bank's target range (1.5% - 3.5%).

The acceleration of inflationary pressures coupled with the accumulation of challenges in the sphere of domestic macroeconomic balance determined the National Bank of Romania (BNR) to increase the reference interest rate from 1.75% to 2.50% in the first half of 2018.

In April 2015, the Bank took control of Volksbank Romania S.A. ("VBRO"), recognizing in the individual and consolidated financial statements the acquisition gain in the amount of 1,650,600 thousand lei as following the business combination in accordance with IFRS 3.

At level 2 of the fair value hierarchy, the Bank and the Group classified in the category of assets that are not held at fair value: investments in banks less securities classified in the category loans and receivables (which do not have an active market), loans, advances and receivables from financial leasing contracts granted to customers, and in the category of debts: deposits from banks and customers.

At level 3 of the fair value hierarchy, the Bank and the Group classified in the category of assets: financial assets valued at amortized cost - debt instruments and other financial assets, and in the category of debt: loans from banks and other financial institutions, subordinated debt and other liabilities financial.

Schultz and Hollister observed in 2003 that, under pressure from conservative banks, the standard required only certain investments, then some of them proposed to be sold in the short term and others prepared using fair value through profit or loss. The standards represented efforts to determine fair values through the profit statement in specific scenarios. In 1998, IASB got IAS 39. At that time, IASB standards were referred to as International Accounting Standards (IAS). Then, FAS 115 was equivalent to IAS 39: Financial Instruments: Recognition and Measurement, (IAS Plus 2019). If fair value measurements are not reliable, then the correlation with future performance measures will not be significant. In 2015, Sodan adopted the concept of measurement, according to which exposure to fair value accounting is measured using global or net income approaches. Then, changes in fair values are reported as gains and losses on net or other global income. In other words, we studied the effect of fair value gains (losses) on other global income and net income on predictability as a measure of the quality of gains. Muller, Riedl and Sellhorn, in 2008, referred to ongoing variations, which cause changes in purchasing power, create instability and can lead to inflation or depression. The concept of fair value has moved traditional accounting theory to new horizons and made a comprehensive change in the structure of financial statements and their implications. Sodan noted in 2015 that this was a result of the evolution of accounting theory in the years that developed and were implemented in international fair value accounting standards and was practiced at the beginning of the third millennium, in 2001. Using the model fair value, the company can obtain a higher income depending on the difference between the fair value and the book value, which is recognized as part of the gain and loss on the application of fair value. Wahyuni, Soepriyanto, Avianti and Naulibasa concluded in 2019 that using the cost model, the value of net income or loss is affected only by depreciation expenses. Among the accounting tasks is the choice of the appropriate valuation method for valuing assets and liabilities. Scientists have confirmed this. Scientists, such as McDonough and Shakespeare, in 2015, admitted that the financial position and results of economic activities represented in the balance sheets and profit and loss statements depend on the current reality and the methods of estimating and calculating the reported indicators. Forecast the company's future cash flows when the market collapses and assets and liabilities appear below. Their real value, this leads to a distortion of the company's financial position and seems unable to achieve the proposed objectives.

3. Conclusions

The predictability, accruals quality, earnings smoothing and value relevance are the most important measures of earnings quality. Earnings quality and the quality of accounting information are in direct relation. The impact of fair value accounting on earnings quality is significant. With the adoption of fair values, earnings predictability at Transilvania Bank Group became quite high due to the variability of income. This thing alters the quality of the earnings and thus affects the choices that stakeholders can make. Consolidated and individual statement of profit or loss and others elements of the overall result is represented in Table 1 below.

Table 1. Transilvania Bank S.A.
Consolidated and individual statement of profit or loss and others elements of the overall result for the financial year ended 31 December

Banking Group

		Banking Group		**Bank**	
	Note	2018	2017	2018	2017
		Thousand lei	Thousand lei	Thousand lei	Thousand lei
Interest income		3,182,049	2,102,621	2,855,070	2,018,571
Interest expenses		-432,500	-211,802	-377,162	-210,122
Net interest income	8	2,749,549	1,890,819	2,477,908	1,808,449
Income from expenses and commissions		1,029,941	744,313	923,948	704,571
Expenses with fees and commissions		-252,233	-143,800	-229,276	-149,905
Net income from expenses and commissions		9,777,708	600,513	694,672	554,666
Net trading income	10	252,163	278,339	263,448	223,667
Net loss on sale of financial assets available for sale	11	-	-3.206	-	-4.102
Net realized loss on financial assets measured at fair value through profit or loss	11	-7,555	-	-7,774	
Net realized loss on financial assets necessarily valued at fair value through profit and loss	12	-2,570	-	-40,529	-
Contribution to the Deposit Guarantee Fund Banking and Resolution Fund	13	-41,423	-49,696	-39,164	-49,696
Other operating income	14	217,591	173,823	245,419	116,196
Operating income		3,945,463	2,890,592	3,593,980	2,649,180
Net expenses (-) / Net income with adjustments impairment, expected loss on assets, provisions for other risks and commitments of credit	15	-364.421	-29.221	-230.791	1.353
Staff costs	16	-1,065,162	-763,227	-965,972	-715,390
Depreciation expenses		-162,514	-125,024	-129,250	-90,106
Other operating expenses	17	-806,615	-530,498	-697,351	-466,537

Operating expenses		-2,398,712	-1,447,970	-2,023,364	-1,270,680
		________	________	________	________
Gain on purchases	50.51	160,077	________	71,830	-
Profit before tax		1,706,828	1,442,622	1,642,446	1,378,500
Income tax expense	18	-446.148	-200.154	-423.055	-192.521

Source: https://www.bancatransilvania.ro/files-aga/situatii-consolidate-si-individuale-la-31-decembrie-2018-situatiile_financiare_individuale_si_consolidate_la_31_decembrie_2018.pdf.

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